

PRIVATE CORPORATIONS AND THE NEW G.R.E. RULES

Tuesday November 3, 2015

A NEW REGIME FOR ESTATES AND TRUSTS

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With thanks and appreciation to
Chris Ireland, PPI advisory, Vancouver
Shelagh Rinald, Rinald Tax Advisory Inc., Victoria
William Fowles, Miller Thomson LLP, Calgary
STEP 2015 National Conference

And acknowledgement of materials presented in their June
19, 2015 presentation entitled "Bill C-43 Changes Impacting
Post Mortem Planning for Privately Held Corporations"

THE NEW G.R.E. RULES

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THE NEW G.R.E. RULES Graduated Rate Estate (“GRE”)

- Effective for 2016 and subsequent years
- A GRE must be an Estate
- Must qualify as a testamentary trust
- No contributions other than on death
- No Non-Arm’s length loans to trust
- Only for the first 36 months following death

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- For 2016 and subsequent taxation years, various post mortem tax planning strategies will only be available to a Graduated Rate Estate (“GRE”). Therefore it is essential that planning is undertaken during the Will Makers lifetime to ensure that any estate that will own shares of a private company following the death of a shareholder will qualify as a GRE as defined in subsection 248(1) of the Act.
- A GRE must qualify as a testamentary trust as defined in subsection 108(1) of the Act.
- An Estate will only qualify as a GRE for the first 36 months following death.

THE NEW G.R.E. RULES

Graduated Rate Estate (“GRE”) – cont’d

- Designated as a GRE in first return that ends after 2015
- Only one GRE per deceased individual
- Resident of Canada

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- The estate must designate in its return for its first taxation year ending after 2015 to be a GRE. This requirement applies regardless of the date of the individual’s death. There is currently no provision for late filing the GRE designation.
- “Subsection 248(1) is amended to add the definition “graduated rate estate”. The graduated rate estate of an individual at any time is the estate that arose on and as a consequence of the individual’s death, if that time is no more than 36 months after the death and the estate is at that time a testamentary trust. The income tax rules are predicated on the understanding that an individual has only one estate that arises on the individual’s death. Consistent with this and the intention that there be only one graduated rate estate in respect of a deceased individual,”
- This suggests that there can only be one estate that is created for any one deceased person. Where an individual dies with two wills, there is still arguably only one estate to be administered.

THE NEW G.R.E. RULES

Graduated Rate Estate (“GRE”) – cont’d

- Subsection 164(6) Election
 - As of January 1, 2016 election can only be made in the course of administering a GRE
- Paragraph 112 (3.2)(a)(iii) 50% Solution
 - Only available to a GRE for 2016 and subsequent taxation years

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- Effective January 1, 2016, the ability to carry losses of an estate, that are created within the first taxation year following death, back to offset gains in the date return pursuant to subsection 164(6) of the Act will only be available to a GRE.
- In order for an estate to qualify as a GRE, it will be essential that the GRE designation be included in the T3 Return of the Estate in its first taxation year ending after 2015 for any estate where the deceased has died within 36 months of January 1, 2016.
- Also, effective January 1, 2016, the ability to utilize the 50% solution to create losses to an estate on the redemption of shares using capital dividends pursuant to subparagraph 112(3.2)(a)(iii) of the Income Tax Act, will only be available to a GRE.
- On this basis, post-mortem planning for an estate which involves the creation of capital losses to an estate using capital dividends and the 50% solution will only be available to a GRE for 2016 and subsequent years.

THE NEW G.R.E. RULES

Key Changes for Alter Ego Trusts (AET), Joint Partner Trusts (JPT) and Spouse Trusts

- Deemed year end on death of settlor/spouse
- Gains taxed in settlor/surviving spouse's return
- 104(13.1) or (13.2) Elections
 - Only available if trust income after the election is nil
 - Timing of loss creation vs. election to have gains taxed in the trust
 - Late filed elections
 - No grandfathering

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All income of the trust up to the date of death (e.g. gains arising from deemed dispositions) will be taxed in the final tax return of the spouse, common law partner or settlor as applicable (rather than the trust).

- Subsection 104(13.3) was introduced by Bill C-43 for 2016 and subsequent years to render a designation under subsection 104(13.1) or (13.2) of the Act invalid if the trust's taxable income (determined as though the designation were valid) for the year is greater than nil. This provision will effectively limit the ability to elect to have income or gains, that are otherwise considered to be payable to a beneficiary, taxed in the trust to only situations where after making such an election the income of the trust will be nil (i.e. the "elected income or gains" will be fully offset by losses of the trust).

WHEN IS AN ESTATE NOT A GRE?

Examples

- Expense paid for Estate by NAL Person (remains outstanding more than 12 months)
 - Not a testamentary trust at the time the debt arises and therefore non-GRE; deemed year end when non-GRE
 - No 164(6) election or 50% solution available
- No designation is filed “in its return”
 - Late file return? Amended return?
 - No (164(6) election or 50% solution available



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- An estate must qualify as a testamentary trust in order to meet the criteria of a GRE. The definition of testamentary trust in subsection 108(1) provides that where:

- “Property has been contributed to the trust otherwise than by an individual on or after the individual’s death and as a consequence thereof”; or
- The trust incurs a debt or any other obligation owed to or guaranteed by a beneficiary or any other person with whom any beneficiary of the trust does not deal at arm’s length (a “specified party”), other than where the amount was incurred in certain very specific situation including where the amount was paid on behalf of the trust and the amount was repaid by the trust within 12 months after the payment was made;

the trust will not qualify as a testamentary trust and therefore such an Estate will not qualify as GRE. Based on the wording of subsection 108(1) the estate will not be considered to be a testamentary trust at the time the loan is made where the amount is not repaid within 12 months. A year end will be triggered for the estate when it no longer qualifies as a GRE.

- Bill C-43 does not permit a late filing for a GRE designation. The designation must be made in the estate’s T3 Return “for its first taxation year ending after 2015”. Consideration could be given to the possibility of amending the T3 Return and including a GRE designation in the amended return in order to meet these filing requirements. This has not been confirmed by the CRA.

WHEN IS AN ESTATE NOT A GRE?

Example

- Two wills (one with donations one with private company shares)
 - One Estate per Will maker? (Finance Technical Notes)
 - Cooperation of Executors; filing one return
 - Two estates? If so, either no donation or loss carryback to date of death return



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- The definition of GRE in section 248 stipulates that “no other estate designates itself as a GRE of the individual...”. Although the explanatory notes provide some comfort that there should only be considered to be one estate created by each deceased individual, to date there has not been any specific remarks in this regard by the CRA in the context of where an individual dies with two wills (often seen in the context of one will to cover assets that require probate and a second will to cover assets that do not require probate, such as shares of a private company).
- The use of any related mechanics of this two will planning will vary from province to province. Concerns could arise where the use of different executors is required for each of the wills and the related tax matters to be dealt within the estate create conflicting results between the two wills.
- If there is any risk that the two wills could be considered to be two estates, planning will require careful consideration to ensure that any post mortem tax planning strategies are not jeopardized through the use of two wills. These matters will become particularly relevant where charitable bequests are anticipated with assets that require probate while post-mortem planning is also required for assets that do not require probate. Both sets of rules will require the estate to be a “GRE”.

WHEN IS AN ESTATE NOT A GRE?

Examples

- Surviving spouse owns private company shares as well as spouse trust owning shares (date of death taxes re spouse trust assets reimbursed or paid by spouse trust)
 - Surviving spouse's estate tainted as testamentary trust therefore non-GRE?
 - No subsection 164(6) or 50% solution to the surviving spouse's estate

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- If the estate is tainted as a testamentary trust, none of the benefits of subsection 164(6), the 50% solution, marginal tax rates or charitable bequests would be available to the estate of the surviving spouse.

POSSIBLE SOLUTIONS FOR A NON-GRE ESTATE

- Review Estate Planning to ensure estate owning private company shares will be a GRE:
 - Provision in will that the Estate cannot take on obligations that could offend the definition of Testamentary Trust in subsection 108(1) of the Act?
 - If two wills used, ensure that it is okay for assets under one will not be owned by a GRE?
 - Spouse/AET or JPT should reimburse taxes to beneficiaries rather than estate of settlor/spouse?

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EXAMPLE 1

FACTS:

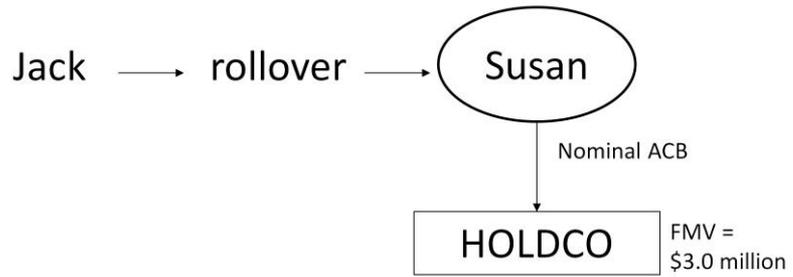
- Jack and Susan married for many years
- Two Children
- Jack owns 100% - shares of HOLDCO with Nominal ACB
- HOLDCO has \$3.0 million of Investable Assets

EXAMPLE 1

FACTS:

- Jack dies and leaves the HOLDCO shares to Susan
- Rollover on Death

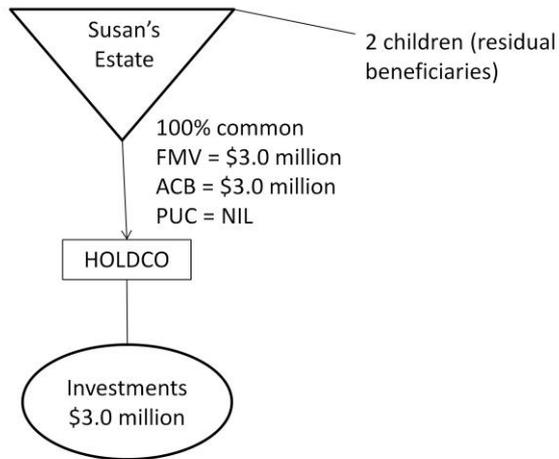
EXAMPLE 1



EXAMPLE 1

- On Susan's death, her Will leaves the shares of HOLDCO to her 2 adult children
- Deemed disposition on death
- Capital gain of \$3.0 million
- Terminal T1 taxes of \$700K

Example 1



WHAT HAPPENS WHEN SUSAN DIES?

	OLD RULES	NEW RULES
Deemed disposition at death	Yes	Yes
164(6) planning available	Yes	Yes
Bump planning available	Yes	Yes

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Capital Loss Planning – The GRE Rules

- Example 1
 - 164(6) election and the 50% solution
 - Require a GRE
 - Designation in the first tax return
 - Estate
 - Testamentary trust definition

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- Capital loss planning is available
 - Must be a GRE – otherwise, the subsection 164(6) election cannot be made
 - Similarly, the 50% solution can only be implemented for an estate that is a GRE

Capital Loss Planning – the GRE Rules

- Example 1 (cont'd)
 - GRE – only for 36 months
 - 164(6) election is required in the first taxation year of the estate
 - What if there is estate litigation, delays, etc??

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- The 36 month timeline for a GRE is really not relevant as the 164(6) planning must be completed in the first taxation year of the estate.
- Any delays due to litigation or for other reasons, will be an issue whether or not there are GRE rules because of this first taxation year requirement for a subsection 164(6) election.

Capital Loss Planning

- Example 1
- Replacing the capital gains with dividends
 - 23% capital gains rate – vs. 40% non-eligible dividend rate
- Why??
- RDTOH, CDA - ??

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- A sec 164(6) capital loss plan will replace the deemed capital gains on death with dividends. If all of the dividends are taxable the results would be as follows:
 - Example 1 - \$3 million capital gain on death (approx)
 - Capital gains tax - \$700,000
 - Eligible dividends - \$960,000
 - Non-eligible dividends - \$1,200,000
 - Taxes have therefore increased
- Should capital loss planning even be considered?
 - Are there significant balances in Holdco's capital dividend account (CDA) and/or refundable dividend tax on hand account (RDTOH)?

Capital Loss Planning

- What if there is CDA?
 - For example - \$1.5 million (say from last to die life insurance proceeds received on the death of Susan).
 - Replacing some of the capital gains with non-taxable capital dividends
 - 50% solution to consider - \$1.5 million of capital loss planning?
 - Plan into the capital dividend stop-loss rules?
 - Combination of the post mortem planning alternatives

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- Let's add another fact/assumption to the scenarios – Holdco has \$1.5 million of CDA.
- Capital loss planning can be a viable alternative for at least the amount of the CDA, as the planning would be essentially replacing some of the capital gains with capital dividends
- A full description of the steps that would be undertaken will not be reviewed here.

Example 2

FACTS:

- Bob and Mary were married for many years
- 3 children
- Mary died of cancer and several years later, Bob is in a common-law relationship with Jill
- Jill has 2 children from her first marriage

Example 2

FACTS:

- Bob was a successful business person
- Sold company assets and now has \$3.0 million in a Holdco
- Bob's will provides for spouse trust for Jill, with all residual assets to his 3 children



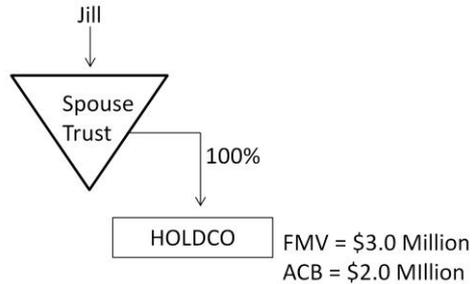
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Example 2

FACTS:

Bob dies – resulting structure in place



The shares of Holdco are transferred to the spouse trust on a rollover basis, with no resulting capital gain on Bob's death. Effectively, the capital gain is deferred until "last-to-die".

Example 2

What Happens When Jill Dies?

- First, lets look at the “old” rules
- Deemed disposition of Holdco shares within spouse trust at FMV
- Tax payable by spouse trust

What Happens When Jill Dies?

Old Rules

- Assume capital gain of \$3.0 million
- Capital gains tax of \$700K
- Options:
 - Continue trust? Potential double tax but for who?
 - Windup Holdco, pay tax in Trust and distribute assets to residual beneficiaries. Capital loss C/B
 - Pipeline strategy?

What Happens When Jill Dies?

For Instance:

	(in \$000's)		
	Do Nothing	Windup Holdco	Pipeline and Bump Strategy
Capital Gains tax in trust	\$ 700	700	700
Tax on Deemed Dividend \$3,000 @ 40%	\$ 1,200	1,200	-
Recovery of Capital Gains Tax on Loss CB	\$	(700)	-
	\$ 1,900	\$ 1,200	\$ 700

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What Happens When Jill Dies?

Old Rules

- Decision depends on
 - Liquidity of investments in HOLDCO
 - Potential gain on investments within HOLDCO
 - CDA within HOLDCO
 - RDTOH
 - Ability to use a “pipeline strategy”

What Happens When Jill Dies?

NEW RULES

- Now, lets look at the new rules
- Deemed disposition of HOLDCO shares within spouse trust at FMV
- New subsection 104(13.3) will not permit a 104(13.2) designation to retain capital gains within trust
- RESULT – deemed capital gain taxed in Jill's terminal T1 return

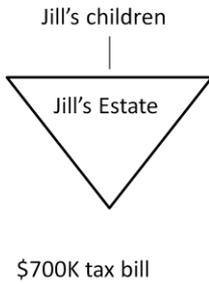
What happens when Jill dies?

NEW RULES

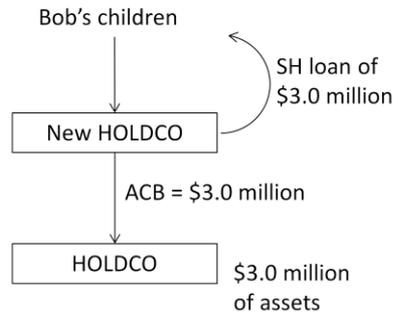
- Jill's estate pays the capital gains taxes of \$700K
- Bob's children get the shares of HOLDCO with a stepped-up ACB of \$3.0 million
- Could use a "pipeline and bump strategy" to extract \$3.0 million tax-free (assuming eligible property within HOLDCO)
- Is this fair? Is it what they intended?

What happens when Jill dies?

Jill's Estate



Residual Beneficiaries Pipeline and Bump Strategy



Graduated Rate Estate (“GRE”)

So... what are the issues?

- Conflicting beneficiary interests?
- Capital loss planning
- Pipeline/bump planning

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Capital Loss Planning

- Why?
 - Elimination of double tax
 - Tax on death; tax on distribution of corporate funds
 - Tax on corporate assets?

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- Why should capital loss planning even be considered? As you can see, in the context of private company shares, there are at least 2 levels of tax. First, there is the capital gains tax on death, and secondly, there is the tax payable when funds are eventually distributed from the corporation. There can be a third level of tax on the actual assets within the corporation.
- Dealing with the corporate tax may be part of the post mortem plan – for example, the pipeline alternative would often be combined with “bump” planning to increase the cost base of qualifying corporate assets (non-depreciable capital property).

Capital Loss Planning

- How is capital loss planning accomplished?
 - 164(6) election?
 - Wind up Holdco
 - Redeem shares
 - Post mortem freeze

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- In order to make a sec 164(6) election, capital loss planning consists of realizing a capital loss in the first taxation year of the estate. However, Jill's estate would not actually own any shares in HOLDCO. The HOLDCO shares are owned by the spouse trust at the date of Jill's death. Therefore 164(6) capital loss planning is irrelevant for Jill's estate.

Capital Loss Planning

- Issues to consider
 - 164(6) capital loss planning – N/A
 - “Regular” capital loss planning – 3 year loss carry back rules
 - Redemption of HOLDCO shares
 - Timing – death of the beneficiary vs. trust’s year end

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- As the spouse trust has the deemed disposition, subsection 164(6) cannot be used.
- Capital loss planning can still be implemented with a three year capital loss carry back window under section 111 potentially applying:
 - The trust would have time to implement capital loss planning provided the trust still owned the shares (discussed on the next slide).
 - Depending on the timing of the death of the beneficiary and when the capital loss planning can be completed, the trust may have to pay the capital gains tax, and then have a refund when the capital loss is realized and carried back to offset the gain.

Capital Loss Planning

More issues...

- Is the trust still in existence?
- Who owns the shares at the time the capital loss is incurred?
 - Distribution of the HOLDCO shares to the residual beneficiary(ies)
- Affiliated stop-loss rules



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- As noted on the previous page/slide, the continued ownership of the shares by the trust is essential
 - Issues and questions to consider include:
 - Has the trust been wound up? – hopefully not! Consider having the trust deed specifically refer to the continued existence of the trust after the death of the beneficiary spouse.
 - Does the trust still own the shares? – hopefully yes! Be careful not to distribute the shares to the residual beneficiaries until after completion of the capital loss planning (and consider having the trust deed specifically address).
 - Do the affiliated stop-loss rules apply? A review of these rules is beyond the scope of this presentation, but the rules could apply to a trust realizing a loss, particularly if a “majority interest beneficiary” of the trust also owns controlling shares in the corporation.

The New GRE Rules

- Spouse Trusts
 - 104(13.4)!!
 - Where is the gain?
 - The beneficiary's tax return
 - Where are the shares?
 - Deemed year end of the trust

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- Subsection 104(13.4) brings some very problematic issues to this scenario.
 - The gain is taxed in the beneficiary's return
 - The shares are owned by the trust (problematic for loss utilization if shares are distributed)
 - Any capital loss planning by the trust would not match up with, and offset, the capital gain realized by the beneficiary

The New GRE Rules

- Spouse trust and JPT
 - Mismatch of the gain and ownership
 - Different sets of beneficiaries?

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- There is a very real possibility for the estate of the beneficiary (with the deemed gain) to have different beneficiaries than the trust (Second marriage scenarios).
- Conflicting interests
 - In particular:
 - Where loss carryback planning is undertaken, taxes will be recovered by the beneficiaries of the estate of the spouse, common law partner or settlor and will become payable (due to redemption of shares of the JPT, AET or spouse trust) by the JPT, AET or spouse trust.
 - Whereas if pipeline planning is undertaken, there will be no additional taxes arising to the JPT, AET or spouse trust.

The New GRE Rules

Possible Solution?

- 104(13.2) – loss carry back and a “late designation”
 - Create the loss in the trust
 - CRA’s views?
 - 104(13.2) – OK because there is no income after applying the capital loss carry back?
- Uncertain whether this could work?
- Amend personal tax filings?

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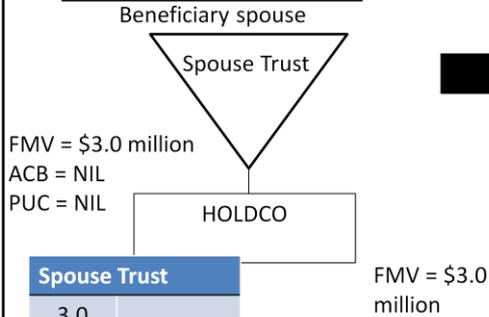
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- What if the strategy is for the trust to realize the capital loss after the death of the beneficiary?
- Assume that the capital loss is realized within a three year window and carried back to offset the deemed gain – no taxable income, but there is net income for purposes of the 104(13.2) designation.
 - Make the designation now, after realizing the loss??
 - 104(13.3) – no income after applying the capital loss carry back and therefore acceptable??

The New GRE Rules

Possible Solution

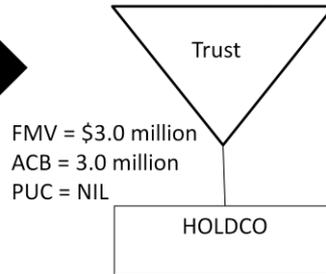


Spouse Trust	
3.0	
-	
3.0	104(13.2)
(3.0)	Loss CB
NIL	

Deemed capital gain on death



Residual capital beneficiaries



- Trust would redeem shares of HOLDCO
- Deemed dividend of 3.0 million
- Capital loss of 3.0 million
- CB capital loss

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The New GRE Rules

What if?

– If there is CDA/RDTH

- Use in the future and implement pipeline planning?
 - But! Who will receive the benefits of the pipeline vs. payment of the tax



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- What about implementing pipeline planning instead?
 - If there is CDA and/or RDTH, consider leaving those for the future
 - Also – if there are different beneficiaries, what is the incentive to implement capital loss planning unless there is significant CDA.
- From the perspective of the residual beneficiaries, there really is no incentive to do any capital loss planning, since they do not have any double tax exposure.
- There is actually an overall tax savings to the beneficiaries of the JPT, AET or spouse trust to the extent that Pipeline and Bump Planning can be undertaken to extract cash on a tax free basis from the corporation.

The New GRE Rules

What if?

- Distribution of shares to facilitate the planning?
 - To the spouse beneficiary/JPT beneficiary
 - Timing issues – i.e., before death
 - Purpose of the trust
 - Terms and conditions of the trust



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- Should the planning instead try to match up the gain and subsequent capital loss by having the beneficiary/estate own shares?
 - Have the beneficiary own the shares before death??
 - Is this practical?? What would the residual capital beneficiaries say?? Is it even possible under the terms of the trust?? In certain spousal trust situations, there may be restrictive capital encroachment clauses or the trustee may feel uncomfortable encroaching on capital to that extent

The New GRE Rules

- Distribution of shares to facilitate the planning? (cont'd)
 - To the estate of the beneficiary
 - 164(6)??
 - Same trust issues re the purpose and terms and conditions of the trust
 - To the residual beneficiaries
 - Another mismatch

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- Can the estate of the beneficiary spouse receive the shares after death??
 - What does the will or trust documents say?
 - Could 164(6) planning then work?

The New GRE Rules

- Other considerations
 - Charitable giving implications
 - Funding for the beneficiary's estate
 - Providing cash to fund the tax bill
 - Legislative changes - ??
 - Grandfathering??

The New GRE Rules

Pipeline Planning and s.88 Bump Planning

- Pipeline Planning
 - Withdrawal of corporate surplus as return of ACB created by a (deemed) disposition that was taxed as a capital gain
- Bump Planning
 - ACB of certain types of capital property owned by a corporation are bumped to take outside ACB in the shares into account
- Both Pipeline and Bump Planning
 - A tax effective result

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In the right circumstances pipeline planning can be an effective approach to reducing the income tax consequences relating to private corporation shares held by an estate, spousal trust or alter ego or joint partner trust on the death of the shareholder or primary beneficiary of the trust.

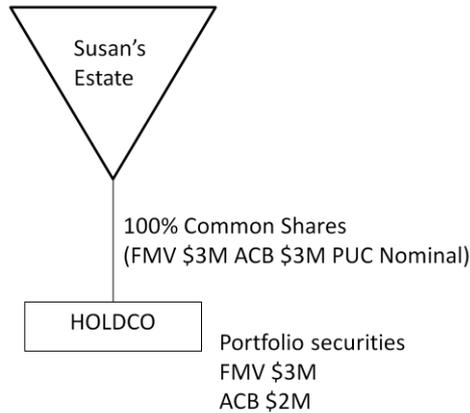
Pipeline planning can be further enhanced by bump planning which can effectively allow the adjusted cost base of certain types of capital property held by the underlying corporation to be bumped up thereby reducing the income tax consequences at the corporate level relating to a future disposition of these assets and increasing the after-tax cash that is received by the shareholder in the corporation.

A taxpayer may implement a pipeline planning strategy with or without the use of connected bump planning. This might occur where the assets held within the corporation do not have significant accrued gains.

On the other hand, bump planning would ordinarily be implemented in connection with a pipeline planning approach that is being implemented.

Pipeline Planning

Example 1



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This situation is where Susan continues to hold common shares in Holdco until her death. On death, Susan will be deemed to have disposed of these shares having a fair market value of \$3,000,000 and a nominal ACB resulting in a \$3,000,000 capital gain that would be reported on her final T1 income tax return. The deemed disposition arising on death will create an adjusted cost base in the Holdco shares owned by the estate. However, the paid-up capital for these shares would continue as a nominal amount.

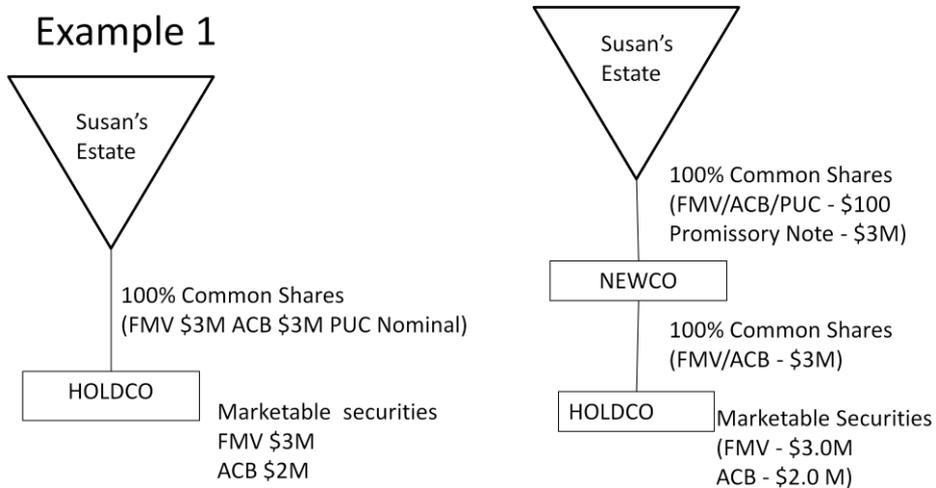
The deemed disposition of the shares in Holdco held by the estate has no impact on the corporation itself. The corporation's assets will continue to have the same adjusted (\$2,000,000) as was the case prior to her death.

The steps utilized to implement a pipeline and bump planning would be as follows:

1. A new corporation ("Newco") that is wholly owned by Susan's estate would be incorporated.
2. Susan's estate would transfer its shares in Holdco to Newco for \$3,000,000 for consideration that includes a promissory note of \$3 million. This transfer of shares could take place on a protective Section 85 rollover basis if there is a concern that the value of the shares in Holdco has increased since death. In order to utilize a protective Section 85 election, it would be necessary for the estate to also receive share consideration as part of the transfer of the Holdco shares to Newco.
3. Newco and Holdco would then either amalgamate pursuant to Section 87 of the *Income Tax Act* or Holdco would wind-up into Newco pursuant to Section 88(1) of the *Income Tax Act*. Each of the Subsection 88(1) wind-up and the Subsection 87(11) amalgamation have certain requirements that must be satisfied for the bump procedure to work.
4. Paragraph 88(1)(d) and its equivalent section in Section 87 permits the adjusted cost base of the underlying securities held by Holdco to be bumped up to, subject to certain conditions, fair market value. This bump would then allow the securities to be sold by AMALCO, with no gain being realized on such sale and the entire sale proceeds being available to pay the promissory note now owing to the estate. As a result of this planning, it is possible that the assets of Holdco can be fully distributed to the estate with the only income tax cost being the tax on the deemed capital gain reported on the final T1 return.

Pipeline Planning

Example 1



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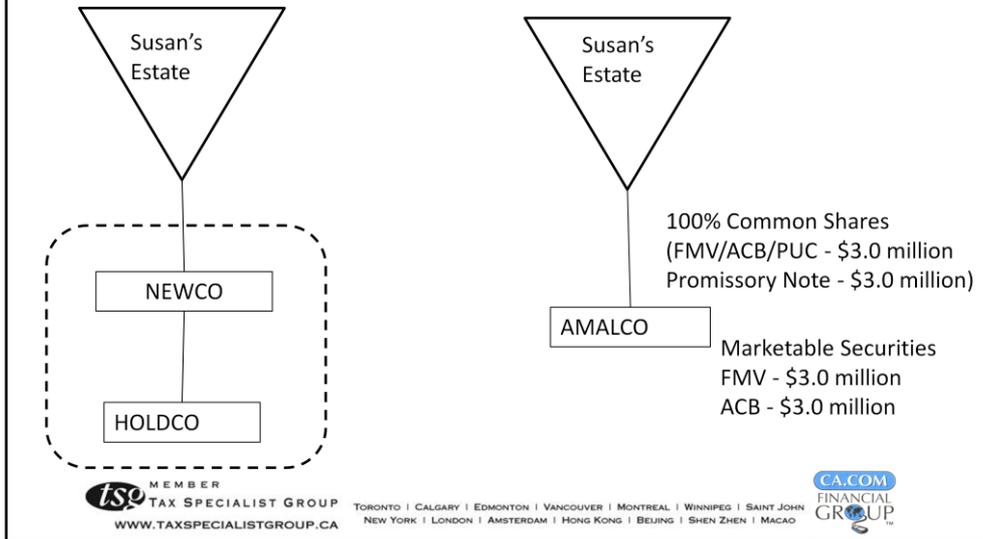
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In this scenario, the executors of Susan's Estate transfer the shares of HOLDCO to NEWCO and effectively "carve out" the stepped-up ACB into a promissory note receivable from NEWCO. This is called the "pipeline Strategy".

Pipeline/Bump Planning

Example 1



Note that on the “vertical amalgamation” of HOLDCO and NEWCO , the ACB of the underlying securities within HOLDCO, get bumped up to the estate’s ACB on the HOLDCO shares. This “bump” strategy effectively permits the assets within AMALCO to be liquidated and distributed to the estate. With no additional tax consequences.

Tax Consequences of Pipeline/Bump Planning

Example 1

- Tax of \$700,000 (Manitoba tax rates) is paid on a \$3,000,000 capital gain on the final tax return
- No tax is paid by Estate on distributions from AMALCO to the extent of ACB in AMALCO shares created from deemed disposition on death of Holdco shares
- Tax is respect of accrued gain on Holdco's assets is eliminated (or reduced)
- Estate nets \$2.3 million
- Total taxes are \$700,000 (23.3%)

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Tax Consequences of Pipeline Only Planning

- Tax on Capital Gain in Estate - \$700,000
- Tax on (\$1M) Capital Gain in Holdco - \$235,000
- \$935,000
- CDA of \$500,000 and RDTOH of \$133,333 left/trapped in Amalco
- Amalco has \$2,765,000 of after tax cash and a \$3.0 million debt owing to the Estate
- Consider Hybrid Planning alternatives



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Pipeline planning on its own will work most effectively where the tax basis in the corporate assets owned by Holdco is greater than or equal to the adjusted cost base of the shares in Holdco owned by the estate (or at least not worth significantly less than the ACB of the Holdco shares) or where the corporation has non-depreciable property and it is possible to utilize bump planning in connection with pipeline planning.

Pipeline planning on its own results in the distribution from Holdco being by way of returning the adjusted cost base of the Holdco shares as either debt or a return of paid-up capital. A dividend is not paid by Holdco to the estate.

As no dividend is paid upon the distribution of the assets by Holdco, there will be no recovery of refundable dividend tax on hand that may exist within Holdco and no payment of any tax-free capital dividends that could otherwise be paid utilizing a capital dividend account of Holdco.

If pipeline planning only is utilized in circumstances where there are unrealized increases in the value of corporate assets and bump planning is not available, utilizing the pipeline planning approach may be less tax effective than either using the Section 164(6) loss carry-back planning in connection with a Section 88(2) wind-up of Holdco or hybrid planning alternatives.

There may be limitations on the ability to utilize bump planning for a number of reasons, including acquisition of control issues, bump denial rules or erosion of the available bump.

If pipeline planning only was utilized by Susan's estate without the ability to implement the additional bump planning, Holdco would incur \$235,000 of taxes on the disposition of the marketable securities resulting in only \$2,765,000 of after-tax cash in Holdco, before any recovery of RDTOH while having a \$3.0 M debt owing to the estate. Tax issues relating to this situation may include whether the estate may realize and deduct any capital loss and whether any capital gains exist that the loss may be applied against.

Tax Issues with Pipeline Planning

- Surplus stripping?
- Loss of available tax balances (CDA, RDTOH, GRIP)

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What is Surplus Stripping

- No precise definition
- Realizing economic value of corporate surplus through a transaction characterized as a sale of shares that gives rise to a capital gain, rather than a distribution from the corporation that is taxed as a dividend



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A good definition of surplus stripping may be realizing economic value of corporate surplus through a transaction characterized as a sale of shares that gives rise to a capital gain, rather than a distribution from the corporation that is taxed as a dividend.

Withdrawing economic value on a basis that is taxed as a capital gain may be a tax efficient realization of share value as capital gains tax rates are normally lower than dividend tax rates, particularly non-eligible dividend tax rates.

Key Provisions of the *Income Tax Act* (ITA) Regarding Domestic Surplus Stripping

- S. 84(2) – Distribution on winding-up, etc.
- S. 84.1 – Non-arm's length sale of shares
- S. 245 – General anti-avoidance rule

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These key provisions regarding domestic surplus stripping involve two very specific rules, being Subsection 84(2) and Section 84.1, and one very general rule being Section 245, referred to as the general anti-avoidance rule (GAAR).

s.84(2)

- Applies to a distribution or appropriation in any manner whatsoever to a shareholder on the winding-up, discontinuance or reorganization of the corporation's business
- Pipeline planning
- CRA's concern relate primarily to cash corporations, which is where pipeline planning would potentially work best

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Subsection 84(2) is a specific avoidance provision that may apply in circumstances where pipeline planning is undertaken. If this section is applicable, the corporation shall be deemed to have paid a dividend equal to the value of funds or property distributed to the extent that such value exceeds any reduction in the paid-up capital relating to the applicable shares and such dividend will be deemed to have been received by the shareholder.

There has been considerable commentary written in recent years regarding Subsection 84(2), recent jurisprudence being the *MacDonald* case and many advance income tax rulings relating to this matter and public announcements by the CRA often at roundtable sessions.

It seems clear that the CRA's concerns relate primarily to corporations that hold primarily cash and/or where the corporation is wound-up and the corporate assets distributed within a reasonably short period of time after implementation of the pipeline strategy.

s.84(2) (cont'd)

- Viable circumstances for avoiding possible application of s.84(2):
 - Able to wait to distribute funds for a sufficiently long time that the initial transaction is not part of the winding-up
 - More than 1 to 2 years safe harbour?
 - Corporation has more than cash
 - Corporation has continuing activity
 - Pipeline Planning in connection with Hybrid Planning can be complementary

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Viable circumstances for utilizing pipeline planning would normally be those situations where a Subsection 84(2) assessment will not occur or is highly unlikely to occur. These circumstances seem to include where the corporation has more than cash, continuing investment and/or business activities and the parties are able to wait a sufficiently long time after the initial pipeline transaction to withdrawal corporate surplus. From advance income tax rulings, there appears to be generally a safe harbour of waiting at least one to two years before assets are withdrawn from the holding corporation in order to avoid the possible application of s.84(2).

An advance income tax ruling may be considered advisable when considering a pipeline planning transaction in circumstances where a possible assessment pursuant to Subsection 84(2) is present.

Pipeline planning in connection with hybrid planning may be complementary.

Timing Considerations re Pipeline and Bump Planning

- Can be implemented in first year of estate or later
- If done earlier rather than later, the clock starts running sooner re timing for distributions from Newco/Mergeco
- Delay in implementation may cause an erosion of the available bump



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As noted in the presentation regarding post mortem planning utilizing subsection 164(6) on the *Income Tax Act*, this loss carry-back planning is only available in respect of capital losses realized in the first taxation year of a GRE. On the other hand, pipeline and bump planning are available to be utilized either in the first taxation year of the estate or in later taxation years, even by the beneficiaries of the estate.

Normally, it is still advisable to implement pipeline and related bump planning as soon as reasonably possible following the death of the shareholder.

One consideration with respect to timing relates to utilization of the safe harbour administrative positions of the Canada Revenue Agency regarding pipeline planning. In many income tax rulings provided by the CRA, the ruling was premised on distributions from the corporation to the shareholder not occurring until after one year from the transfer of the shares to Newco. The earlier the transfer of shares in Holdco to Newco is implemented by Susan's estate, the sooner the clock starts running with respect to potential distributions from Newco/Mergco.

It is possible for the amount of the available bump to be eroded or reduced in a number of circumstances, which are discussed in more detail below. Delaying the implementation of the pipeline and related bump planning can have an adverse effect in terms of eroding or reducing the bump room that may ultimately be available.

s. 88(1)(d) Bump

- Very complex rules
- Nature of property that can be bumped
- Limitations on available bump
- Requirements for corporate structure
- Timing of acquisition of control issues
- Erosion of the bump issues
- Bump denial rules

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Paragraph 88(1)(d) bump can be used to avoid or reduce double taxation by addressing the problem associated with inheriting shares with high cost base and low paid-up capital owned by a corporation which itself also has assets in respect of which there is unrealized gain. However, the rules are highly complex and contain potential pitfalls and traps that may adversely impact the effectiveness of this planning.

This slide identifies the issues that will be reviewed in connection with bump planning.

These issues were addressed in more detail in the Presentation on Post Mortem Planning for Privately Held Corporations at the 2014 STEP Canada National Conference.

Nature of Property that can be Bumped

- Eligible
 - Non-depreciable capital property e.g. land, shares, partnership, interest, debt instrument
- Non-Eligible
 - Depreciable property, eligible capital property (goodwill)
 - Property to which the bump denial rules apply (could extend to eligible property)



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The bump is only available in respect of certain property.

Paragraph 88(1)(c) provides for an increase in the adjusted cost base of capital property other than “ineligible property” pursuant to paragraph 88(1)(d) provided certain requirements are met.

The concept of “ineligible property” is complex. Ineligible property consists of all of the following:

- Depreciable property,
- Property transferred in the same series of transactions as part of a butterfly reorganization under s.55(3)(b),
- Property acquired by the subsidiary corporation from the parent corporation or a person not dealing at arm’s length with the parent corporation, and
- Any property of the subsidiary if the backdoor butterfly bump denial rule applies.

After eliminating the types of property which would be ineligible property, in general, the capital property that may be eligible for the bump will likely be one of the following:

- Land,
- Shares in a corporation,
- An interest in a partnership, or
- A debt instrument, such as a bond, debenture or other receivable.

Limitations on Available Bump

- Amount by which a property can be bumped is subject to two limits:
 - An overall bump limit equal to the difference between the outside basis (ACB of the subsidiary's shares to Parentco) and the inside basis (sum of subsidiary's money and the cost amount of assets less the sum of debts and certain reserves) and less all taxable dividends and capital dividends received on the shares by the parent corporation
 - The fair market value at the time control of the subsidiary was last acquired by the parent or and NAL person.



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The amount by which an eligible property may be bumped is subject to two limits. One of these limits is contained in s.88(1)(d)(i) and is calculated immediately before the wind-up of the subsidiary corporation into the parent corporation. This limitation results in an overall bump limit equal to the amount by which the cost amount of the subsidiary corporation's shares at the time the parent corporation last acquired control exceeds the total of the amount by which the cost amount of all properties owned by the subsidiary corporation immediately before the wind-up (including the cost of any money on hand) exceeds, (i) the total debts of the subsidiary corporation immediately before the wind-up and reserves deducted in computing the subsidiary corporation's income and (ii) the total of all taxable dividends and capital dividends received on the shares in the subsidiary corporation by the parent corporation.

The second limitation on the available bump contained in s.88(1)(d)(ii) is that the amount of bump designated to each eligible property cannot exceed the amount by which the fair market value of the particular eligible property at the time the parent corporation last acquired control exceeds the cost amount of the property immediately before the wind-up.

Both of these rules can limit the amount of the increase in the ACB of eligible capital property that is available.

The manner in which the overall bump limit operates can cause an erosion or reduction in the available bump as more fully discussed below.

Requirements for Corporate Structure

- S.88(1)
- S.87(11)
- Holdco must be wholly-owned (s.87) or 90% owned (s.88) by Newco



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To utilize Bump planning, the requirements in subsection 88(1) for a winding-up or the requirements in subsection 87(11) regarding a vertical amalgamation must be satisfied.

The requirements for a subsection 88(1) winding-up include the following:

- The parent corporation and subsidiary corporation must be taxable Canadian corporations;
- The parent corporation must own at least 90% of the shares of each class of the subsidiary corporation; and
- Any other shares must be owned by arm's length parties.

The requirements for a subsection 81(11) vertical amalgamation include the following:

- The amalgamated corporation must receive all of the property of the predecessor corporations;
- The amalgamated corporation must assume all of the liabilities of the predecessor corporations;
- All shareholders (other than predecessor corporations) must receive shares of Amalco; and
- The subsidiary must be wholly owned by the parent.

Generally speaking, these notes discuss bump planning utilizing paragraph 88(1)(d) although section 87(11) also causes the same result where applicable by providing that cost of property owned by a subsidiary corporation may also be bumped on an amalgamation.

Timing of Acquisition of Control Issues

- Only property owned by the subsidiary at the time its control was last acquired by Parentco and without interruption until distribution into Parentco is eligible for the bump
- Value of subsidiary's property when control was acquired impacts the amount of available bump
- Having an acquisition of control occur as a consequence of death is important
- Later acquisition of control is better
- S.88(1)(d.3) deems that control has been acquired from an AL person when the acquirer acquired shares (and control) as a consequence of the death of an individual. Value of shares at the date of death is used to determine outside basis.



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Issues regarding the timing with respect to acquisition of control are important to manage and plan for it in order to fully benefit from bump planning and avoid unintended limitations on the available bump room.

Only property owned by the subsidiary corporation at the time its control was last acquired by the parent corporation and without interruption until distribution into the parent corporation is eligible for the bump.

As a starting point, for the cost of assets to be increased under bump planning, there must have been an acquisition of control. In example 1, the estate transferred the shares of Holdco to Newco, causing Holdco to be a wholly owned subsidiary of Newco. In order to obtain the bump, Newco must have acquired control of Holdco at the time of the transfer.

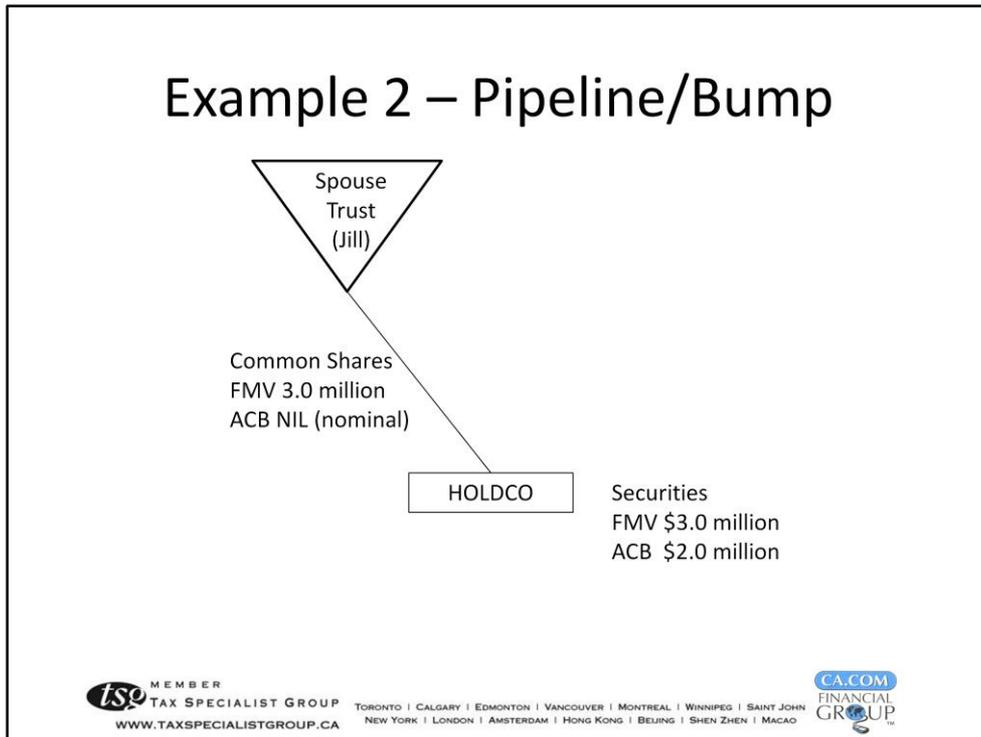
Paragraph 88(1)(d.2) states that where control of the subsidiary corporation is acquired from another person with whom the acquiror was not dealing at arm's length, the acquiror will be deemed to have acquired control when the vendor last acquired control. In Scenario 1, the estate may not be dealing at arm's length with Susan and therefore the date of control of Holdco may not be when Susan's estate acquired control of Newco, but when Susan acquired control of Holdco. If this is the result, there may not be significant available bump room that could be used to increase the cost of Holdco's eligible property, depending upon when Susan last acquired control of Holdco. However, there is a relieving provision in paragraph 88(1)(d.3) for post mortem situations that overrides paragraph 88(1)(d.2).

Paragraph 88(1)(d.3) deems an acquisition of control to have been acquired from a person who does deal at arm's length when the acquiror acquired the shares (and control) as a consequence of the death of an individual. This paragraph allows for the available bump room to be determined using the value of the shares as at Susan's death. This relieving provision is important as the cost of the shares on the date of acquisition is a key factor in the calculation of the bump.

Generally speaking, it is more beneficial to have an acquisition of control occur later in time where assets within the corporation and therefore the value of the corporation have been increasing.

In example 1, the available bump room on the winding-up of Holdco into Newco should be \$1 million, allowing the adjusted cost base of the marketable securities owned by Holdco to be bumped from \$2 million to \$3 million, being the fair market value at the time control of Holdco was acquired by the estate.

Example 2 – Pipeline/Bump

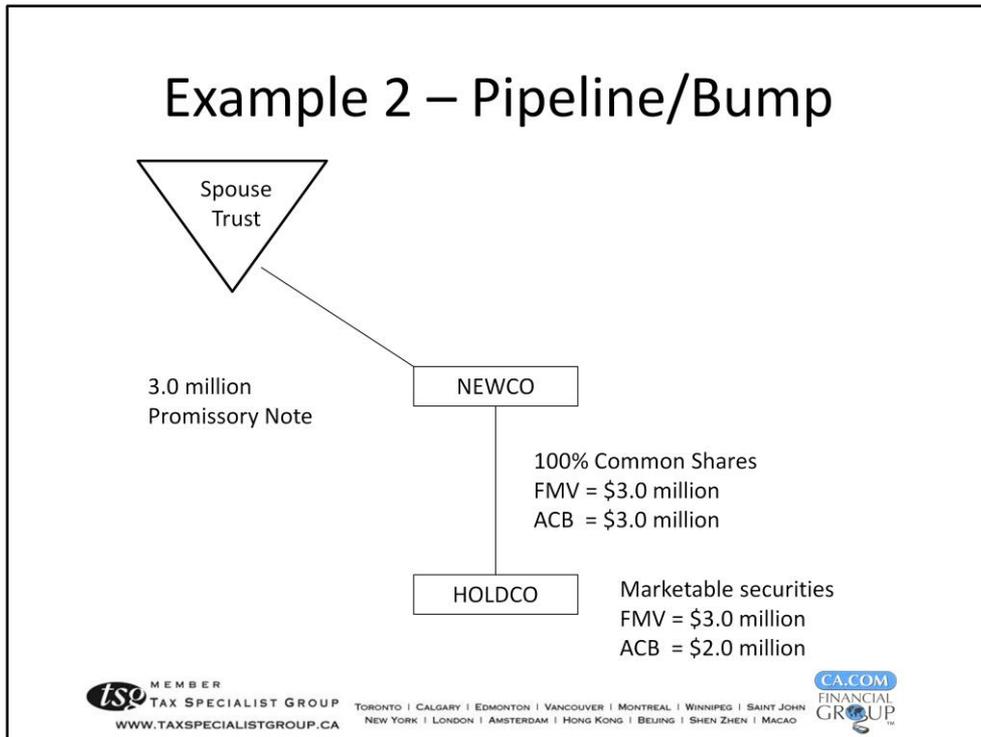


Let's go back to the example of Bob and his second relationship with Jill.

The spouse trust for Jill will be deemed to have disposed of its common shares in Holdco having a fair market value of \$3,000,000 and a nominal ACB resulting in a \$3,000,000 capital gain that would be reported in the T3 trust income tax return filed for the taxation year that is deemed to end on Jill's death. This capital gain will in turn be deemed to be payable to Jill pursuant to subsection 104(13.4) and would be reported on her terminal T1 return. Pursuant to subsection 160(1.4), the spouse trust/joint partner trust is jointly and severally liable for the taxes owing by Jill's estate to the extent of the liability resulting from the s.104(13.4) income inclusion. The deemed disposition arising on death will create an adjusted cost base in the Holdco shares owned by the spouse trust/joint partner trust. However, the paid-up capital for these shares would continue as a nominal amount.

The deemed disposition of the shares in Holdco held by the spouse trust/joint partner trust has no impact on the corporation itself. The corporation's assets would continue to have the same adjusted cost base as was the case prior to Jill's death.

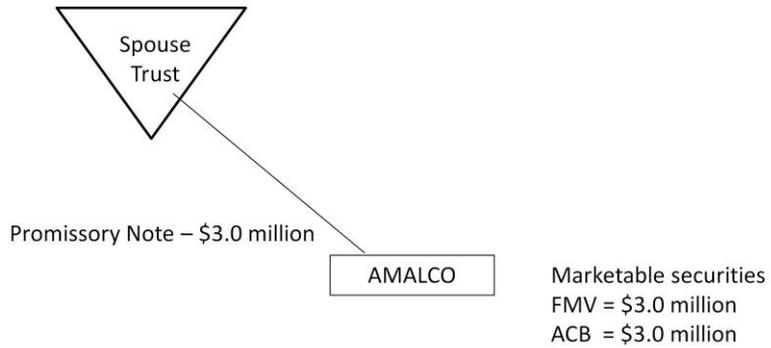
Example 2 – Pipeline/Bump



The steps utilized to implement the pipeline and bump planning in this scenario would be as follows:

1. A new corporation (“Newco”) would be incorporated.
2. The spouse trust would transfer its common shares in Holdco to Newco for \$3,000,000 in consideration that includes a promissory note granted by Newco equal to the FMV and ACB of the shares in Holdco. If the value of the shares do not increase after Jill’s death, there may be no requirement to transfer these shares on a protective section 85 rollover basis. A straight sale could suffice.
3. Newco and Holdco would then either amalgamate pursuant to section 87 of the *Income Tax Act* or Holdco would wind-up into Newco pursuant to section 88(1) of the *Income Tax Act*.
4. Paragraph 88(1)(d) and its equivalent section 87 allows the adjusted cost base of the marketable securities owned by Holdco to be bumped up to, subject to certain conditions, to the lesser of the FMV of such securities and the estate’s ACB on the shares it holds.

Example 2 – Pipeline/Bump



Bump Planning – Example 1

- Planning during Jill’s lifetime regarding voting control of Holdco is important
- To utilize s.88(1)(d.3), spouse trust or Jill must retain control of Holdco (voting only shares could be used)
- Balancing the effect of who has control of Holdco for decision making/succession purposes vs tax consequences that are impacted by whether an acquisition of control occurs
- Consider also different residual beneficiaries

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It is essential to address the acquisition of control requirement relating to bump planning during Jill’s lifetime in order to effectively use bump planning. In example 1 for instance, if the testator did not have voting control of Holdco or if there was no acquisition of control as a consequence of her death occurring, there would be no acquisition of control of Holdco as a result of the testator’s death and the amount that can be bumped will be limited to the cost amount of the Holdco shares, being in this case a nominal amount.

Where there is an inter-vivos freeze involving other family members prior to a gift-over at death, serious consideration must be given to “acquisition of control” issues.

It is to be noted that planning to most effectively utilize the bump may have an effect on decision making, corporate governance and succession planning for Holdco. It is important to balance the varying objectives of the shareholders in Holdco, particularly in a second marriage situation. In this regard, an appropriately drafted unanimous shareholder agreement should assist.

Bump Planning – Example 2

- To utilize s.88(1)(d.3), voting control of Holdco should be in the spouse trust so that the residual capital beneficiaries of the spouse trust acquire shares in and control of Holdco as a consequence of the death of Jill pursuant to the terms of the trust or
- The voting shares in Holdco could be held by Jill instead of by the spouse trust (with participating shares held by the spouse trust) and voting shares pass to the children as a consequence of death

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In addressing voting control of Holdco and whether there will be an acquisition of control as a consequence of the death of Jill (example 2 – second marriage), it would be possible to have voting control held prior to her death by either Jill or the spouse trust.

Issues/Differences re Scenerio 2 vs 3

- Similar considerations exist
- Terms of Spouse Trust can be amended more easily up to date of Bob's death/incapacity that the terms of the spouse trust
- Post mortem loss carry-back planning may be carried out within the three years following death where shares are held by a life interest Trust
- May be easier to create a joint partner trust (JPT)



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It should be noted that the testamentary spouse trust set up for Jill after Bob's death (example 2) will not be permitted to benefit from graduated tax rates after 2015. With respect to flexibility regarding the structure and the ability to adapt to future changes, it would seem that the terms of a spouse trust could be more easily amended up until the date of death or incapacity in comparison to amending the terms of Bob's trust given that the spouse trust is included in Bob's Will which can be easily amended by him until his death or incapacity.

If Bob died or suffered incapacity, his will cannot be readily amended. It is possible that the terms of a joint partner trust could be drafted in a manner that would allow amendment to the trust terms to occur in order to adapt to future changes in income tax rules.

With respect to estate administration, it may be easier to utilize a joint partner trust as the trust can be created prior to Bob's death and would be ready to proceed with ownership of and planning with respect to the shares in Holdco owned by the joint partner trust. In comparison, the testamentary spouse trust would only be created after the estate administration was sufficiently advanced in order to result in the testamentary spouse trust owning the shares in Holdco.

Impact of New Trust Rules in Bill C-43 on Pipeline and Bump Planning

- No direct effect
- Pipeline planning will be easier to implement than loss carry-back planning
- Avoids necessity to make “amended” subsection 104(13.1) or (13.2) Designations needed to Implement Loss Carry-back Planning
- If an estate cannot do loss carry-back planning, it may need to do pipeline planning

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The new income tax rules with respect to estates and trusts contained in Bill C-43 do not directly impact pipeline planning and bump planning. However, as the new rules may adversely affect the ability to utilize loss carry-back and related hybrid planning, the opportunity to use pipeline and bump planning may become more important.

Pipeline planning will also be easier to implement than loss carry-back planning and hybrid planning as it avoids the necessity to amend prior year's trust returns and the terminal return of a deceased including the making of a subsection 104(13.2) designation. As such, the pipeline planning may be easier to implement.

Pipeline Planning and New ss.104(13.4)

- Pipeline planning preferred by beneficiaries of life interest trusts
- Beneficiaries of LIT get bumped up ACB of shares
- Beneficiaries of estate have primary tax liability on s.104(13.4) income inclusion
- Mismatch of tax liability and ownership of assets is perpetuated with pipeline planning
- Loss carry-back planning shifts tax liability to the trust and matches up the tax liability with the assets



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Pipeline planning may be preferred by the residual beneficiaries of the trust (such as a spouse trust or joint partner trust), particularly if the tax liability that created the adjusted cost base in the shares was paid by the life interest beneficiary rather than by the life interest trust. It is to be noted that pipeline planning perpetuates the mismatch of the tax liability and the ownership of assets. On the other hand, loss carry-back planning shifts the tax liability back to the trust, which would be the tax payable on a taxable dividend resulting from the disposition of the Holdco shares. It matches up the tax liability with the ultimate ownership of assets by the residual beneficiaries.

Loss carry-back planning and hybrid planning must be carried out by either the GRE or the life interest trust. It would be possible for pipeline planning to be implemented by the beneficiaries of the life interest trust or estate once the shares have been transferred to and are owned by the beneficiaries.

Think Ahead with respect to Post Mortem Tax Planning

- What is the likely approach that will be used?
- Establish a well position corporate structure
- Build in flexibility for future changes

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It is suggested that the likely approach to post mortem planning be assessed as a part of an estate planning analysis and that the appropriate corporate structure and ownership of shares be established during the testator's lifetime.

It is advisable where possible to establish a corporate structure as part of the estate planning for the shareholder in a private corporation that is well positioned to make effective use of pipeline and bump planning to achieve a favourable post mortem tax result. In this regard, planning should address the need for an acquisition of control as a consequence of death to occur and the shares representing voting control being owned accordingly.

In order to accommodate changes in income tax rules, suitable flexibility should be built into the estate planning documents, such as the Will and the terms of any trusts that are established.

Questions??

Thank you!

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See you on Tuesday, December 1, for the next
TSG Seminar on “Charitable Giving”

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